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Financial Markets and Uncertainty

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"Financiers live in a world of illusion," said George Bernard Shaw, and never has this been truer than in the past decade, when everything has had to be viewed through the prism of inflation. But financiers also deal with the very real world of the marketplace, and the resulting conflicts between reality and inflationary illusions have led to serious distortions in various segments of the market and in broad monetary relationships. The 1970's thus have developed into a decade of financial uncertainty, unlike any decade since the 1930's.

The four papers in this issue discuss the responses to increased uncertainty occurring in four separate financial markets—the mortgage market, the debt market, the equity market, and the money market. The responses may differ in each case—for example, an institutional response in the mortgage market and a market response in the debt market—but all represent aspects of a general attempt to compensate for uncertainty in financial markets.

George Kaufman examines some of the structural changes brought about by inflationary uncertainty in the imperfectly functioning mortgage market. He compares the conventional fixed interest rate mortgage (FRM) with an alternative mortgage plan containing a variable rate (VRM), and shows how the latter has developed as a response to the uncertainty facing lenders and borrowers of long-term mortgage credit.

The industry, faced with an inflationary environment, has created the VRM in order to reduce the financial pressures on mortgage-lending intermediaries, to increase the flow of funds through the mortgage market, and to stimulate the purchase of additional housing. Kaufman describes how the VRM breaks the link between long maturity and high risk associated with uncertainty regarding future interest rates—two characteristics which the traditional FRM mortgage contract combines. By decoupling the current interest charge from the future interest rate, the risks surrounding future interest cost are transferred—all or in part—from the lender to the borrower. With lenders feeling a lower risk they will be more willing to undertake mortgage financing. The lowered risk should also mean that a VRM will have a lower expected cost to the borrower over the life of the mortgage than an equivalent FRM.

In Kaufman's view, "The VRM is a complex instrument, much more complex than first analysis would suggest, and there is good evidence that it is not yet fully understood by any of the parties concerned—borrowers, lenders or regulators." The recent experience of seven California financial institutions suggests that the VRM can operate successfully, but only under certain specific conditions. "The California experience to date suggests that it may not be easy to realize the full potential of this mortgage instrument."

Joseph Bisignano, in a second paper, analyzes the bond market's response to the uncertainty created by unanticipated inflation. The market has experienced not only a dramatic rise in yields on long-term debt securities, but also a change in the spreads between different grades of corporate and municipal bonds, and in the spreads between yields on prime-grade corporates and yields on long-term Government securities. This raises the question whether the market has been "efficient" in establishing yield differentials of this type.

Bisignano's response is that the market has been efficient in removing any systematic profits

available by arbitraging across different grades of securities—for example, between Aaa and Baa bonds—but that it has not been efficient in establishing the differential between prime-grade corporates and long-term Government bonds. "The difficulty in determining this spread appears to be related to the unprecedented rise in unanticipated inflation experienced since the late 1960's." Unanticipated inflation has caused the market to demand much greater premiums for prime corporates over Governments than the underlying risk would have justified. Long-term Governments apparently have lost some of their role as a "safe asset" in long-term portfolios, and this has impaired the market's ability to determine the appropriate spread between the two types of bonds.

Herbert Runyon analyzes the shifting relationships of debt and equity in corporate balance sheets, under the spur of inflation and increased uncertainty. These changes, he says, can be viewed as a matter of corporate treasurers trying to find the best mix of equity and debt in response to the uncertainty of the past decade.

Manufacturing corporations financed themselves rather conservatively until about the mid-1960's, but then began to expand the debt in their balance sheets in an attempt to increase the rate of return on equity shares. For a while they were successful, widening the spread between the return on equity and the return on assets. "This was altogether in tune with the temper of the Sixties, when performance was the name of the game and the bottom line took precedence." But then a day of reckoning came in the 1970's, when highly leveraged firms became increasingly exposed to higher market interest rates and to cyclical fluctuations in corporate earnings.

Corporate treasurers seem now to have rethought the virtues of high leverage ratios. There have been no increases in leverage in recent years, following a period of steady rise toward more risky financing in the late 1960's. Recent emphasis on cash flow suggests a return to a lower mixture of debt to equity finance. To the extent that external financing is required in the future, it is likely to be met with greater stock market financing and less reliance on bonds and and on bank borrowing.

Rose McElhattan's paper considers the puzzling overforecast of money growth which economists' money demand relationships have produced since mid-1974, thus demonstrating how a useful money-market equation can go astray in an era of uncertainty. She points out that forecast money growth was about twice as great as actual money growth for the first year of the current recovery—a finding which throws doubt on the ability of standard models of the U.S. economy to forecast GNP. But after examining the GNP forecast errors developed in a large quarterly econometric model, she concludes that the current relation between money and income has remained similar to its past behavior.

McElhattan examines several alternative explanations for this situation, the most persuasive one being that the public's demand for money has not really changed. In other words, the observed errors may be the fault of the misspecification of the equation used to predict the public's actual demand for money. But although this provides a plausible explanation of the equation's erratic behavior, a good portion of the overforecast remains unexplained. Uncertainty appears to be at the root of the problem. In the real economy, for example, the recent business decline—the steepest of the past generation—was much worse than expected, and thus generated enough uncertainty to destabilize traditional money-demand relationships.